

OFHEO may provide written notice of such inadequacy or deficiencies thereof to the Enterprise OFHEO or seek additional information from the Enterprise regarding the plan.

vi. *Amendment of compliance plan.* An Enterprise that has filed a required compliance plan to which no objection has been raised by OFHEO may, after prior written notice to and approval by the Director, amend the plan to reflect changes in circumstance, policies and procedures.

II. *Failure to submit acceptable plan or to comply with plan.* If an Enterprise does not submit an adequate and complete plan as required by the agency within the time specified by OFHEO or does not implement such an adequate and complete plan, the Director may require the Enterprise to correct any deficiency and may require additional corrective or remedial actions by the Enterprise as deemed to be appropriate pursuant to the Act, including sections 1371 (12 U.S.C. 4631), 1372 (12 U.S.C. 4632), and 1376 (12 U.S.C. 4636).

APPENDIX B TO PART 1720—POLICY GUIDANCE; NON-MORTGAGE LIQUIDITY INVESTMENTS

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A—PURPOSE

1. Fannie Mae and Freddie Mac (the Enterprises) were chartered by Congress as government-sponsored enterprises with public missions. They perform an important role in the United States mortgage market by gathering funds and purchasing mortgages from mortgage originators and guaranteeing mortgage-backed securities. In chartering the Enterprises, Congress charged the Enterprises with: (1) providing stability to mortgage markets; (2) responding to the changing capital markets; (3) assisting the secondary markets including the support of these markets for affordable housing; and (4) promoting access to credit throughout the country by increasing liquidity and improving distribution of investment capital for residential mortgage finance. These functions require the Enterprises, as principals in the secondary mortgage market, to serve as bedrock in providing liquidity to the U.S. housing finance system.

2. For the Enterprises effectively to perform their public purposes, they must be financially sound and liquid. As the Enterprises' financial safety and soundness regulator, OFHEO conducts its regulatory programs to ensure these companies adhere to safety and soundness standards. In addition, OFHEO interprets this to include height-

ening the positive effect of market discipline on the Enterprises by encouraging quality disclosures, appropriate accounting standards, and state-of-the-art risk management further strengthens their safety and soundness. More specifically, OFHEO conducts comprehensive safety and soundness examinations and requires the Enterprises to adhere to regulatory capital requirements. In conducting its regulatory programs, OFHEO applies a series of safety and soundness standards to assess the Enterprises' liquidity management, including their investments in non-mortgage liquidity assets. It is appropriate to issue initial guidance that addresses the safety and soundness standards OFHEO uses to evaluate Enterprise investment activities in non-mortgage liquidity assets.

3. Further, it should be noted that the Secretary of HUD, who has general regulatory power over the Enterprises and who is required to make such rules and regulations as necessary to ensure that the purposes of the GSE's respective Charter Acts are accomplished, has issued an Advanced Notice of Proposed Rulemaking on possible substantive and/or procedural rules governing the GSEs' non-mortgage investment activities. Accordingly, the GSEs may be subject to regulations in this area through future HUD actions, in addition to this initial guidance.

B—ACTIVITIES COVERED

1. The Enterprises must maintain sufficient liquidity to meet both known and unexpected payment demands on borrowings and mortgage securities, for operations and to purchase mortgage assets. Liquidity management is the process by which the Enterprises manage the use and availability of various funding sources to meet current and future needs. Liquidity must be closely managed on a daily basis.

2. The Enterprises manage liquidity through three primary channels: securitizations, issuance of debt and conversion of liquid assets into cash. It is through careful management within and among the three channels, that the Enterprises can effectively meet demands and remain safe and sound under all market conditions. This Guidance specifically addresses "non-mortgage liquidity investments" which are conducted within the liquidity channel whereby the Enterprises are able to convert their own assets into cash.

3. There are various types of investments that may be appropriate for non-mortgage liquidity holdings. Appropriate non-mortgage liquidity investments are characterized by both creditworthiness and low price volatility. Even though an investment may be creditworthy, if the holding is subject to undue price volatility (e.g. common stock), the investment is inappropriate for inclusion

in the non-mortgage liquidity portfolio since the investment may not be readily converted into cash without substantial loss.

4. For the purposes of this Guidance, the types of assets listed below are generally considered to be appropriate non-mortgage liquidity investments. This list is subject to revision over time as new asset types are introduced and/or market activities change. The presence of an asset on the list does not mean that OFHEO will necessarily consider any and all Enterprise investments in these assets to be safe and sound, especially if they fail to meet appropriate credit quality, maturity and diversification objectives:

- a. Debt issued by the United States Treasury,
- b. Debt issued by U.S. Government Agencies,
- c. General obligation debt issued by states and municipal authorities,
- d. Revenue obligations issued by states and municipal authorities,
- e. Corporate debt instruments,
- f. Money market instruments,
- g. Non-mortgage asset-backed securities, and
- h. Reverse repurchase agreements.

5. This Guidance does not address investments in mortgage-backed securities, mortgage revenue bonds, or other investments secured by housing (including commercial mortgage-backed securities with a significant housing component) since these assets are not principally held for liquidity purposes. Also, upon implementation of FAS 133, this Guidance is not intended to address the use of derivative instruments. For activities not covered in this Guidance on non-mortgage liquidity investments, there should be no inferences drawn about OFHEO's views.

C—STANDARDS FOR NON-MORTGAGE LIQUIDITY INVESTMENT ACTIVITIES

To ensure there are sufficient funds available to the mortgage market, the Enterprise must actively manage liquidity across all three channels. OFHEO assesses the safety and soundness of non-mortgage liquidity investment activities against five criteria. The five criteria and details about each of the criteria are:

- Prudent investment policies and procedures that guide the Enterprise's process;
- Quality management information that ensures timely performance measures and governance data;
- Safe & sound investment holdings and investment culture;
- Quality controls and personnel administering and governing the process; and
- Independent testing of the process to assure compliance.

1. Prudent Investment Policies and Procedures That Guide the Enterprise's Process

a. The Enterprise must have a comprehensive written investment policy that clearly expresses the goals for the non-mortgage liquidity investment activities. The Board of Directors and management must evaluate the effectiveness of non-mortgage liquidity investments in meeting the goals set out in the policy; and management must evaluate activities against the procedures and limitations in the policy. At a minimum, the policy should cover:

- i. The purpose of the non-mortgage liquidity investment holdings;
- ii. The institutional goal(s) for the non-mortgage liquidity investment holdings;
- iii. The authorized instruments and activities;
- iv. The internal control standards;
- v. The limits structure;
- vi. The performance standards and measures; and
- vii. The reporting requirements.

b. The policy should clearly document the purpose for non-mortgage liquidity investment holdings. Management should install a series of procedures and controls that produce behaviors and performance that are consistent with the defined purpose for the non-mortgage liquidity investment activities.

c. The policy should establish the primary goals for the non-mortgage liquidity investment activities. For an Enterprise, some primary goals should be to augment liquidity and to generate a rate of return that is reasonable in light of the purpose of such investments. The emphasis placed on individual goals may vary based upon institutional differences. However, non-mortgage liquidity investments made with a goal of maximizing earnings or maximizing arbitrage opportunities would be inconsistent with this Guidance for the maintenance of an Enterprise's liquidity portfolio.

d. The policy should clearly define the authorized investment vehicles and establish guidelines for the introduction of new types of investment vehicles.

e. The Enterprise's procedures should include a framework of controls that provide an appropriate separation of duties and responsibilities. There should be responsibility assigned for an independent review of non-mortgage liquidity investments by a designated unit, such as audit or an independent risk oversight group.

f. The Enterprise should adopt a limit structure to promote diversification in the non-mortgage liquidity investment portfolio and emphasizes strategies for risk mitigation. Additionally, there should be limits for the aggregate size of the non-mortgage liquidity investment portfolio.

g. The Enterprise should adopt measures to evaluate performance against the policy and its objectives.

h. The Enterprise should adopt internal reporting requirements that quantify performance, document exceptions, and serve as a basis for communicating information about activities involving non-mortgage liquidity assets.

i. The Enterprise should periodically evaluate the adequacy and content of its public disclosure for non-mortgage investment liquidity activities.

2. Quality Management Information That Ensures Timely Performance Measures and Governance Data

a. The Enterprise must maintain systems that adequately identify, measure and report the nature and level of exposure associated with their non-mortgage liquidity investments. Management must remain appropriately informed about the activity in non-mortgage liquidity investments. Also, the Board of Directors should periodically be provided a summary of non-mortgage liquidity investment activities. At a minimum, management's reports to the Board should:

i. Summarize non-mortgage investment activity since the last report;

ii. Identify and explain any material changes or trends in the non-mortgage liquidity investment portfolio risk and returns; and

iii. Report and explain exceptions to the policy or risk guidelines for liquidity investments.

b. Meaningful changes in portfolio volume and spreads from period to period should be identified and explained to the Board in terms of why they occurred (*e.g.*, changes in portfolio composition, changes in funding costs, etc.). In overseeing the day-to-day management of non-mortgage liquidity investment activities, management should consider the discrete risks associated with the non-mortgage liquidity investment portfolio as well as the exposure of this portfolio within the context of risks across the entire Enterprise. This includes assessing the non-mortgage liquidity investment portfolio's sensitivity to changes in interest rates, expressed in terms of net interest income sensitivity and portfolio value sensitivity.

3. Safe and Sound Investment Holdings and Investment Culture

a. The Enterprise should implement and enforce policies and/or procedures for non-mortgage liquidity investments. Management should establish limits and procedures in a manner that is consistent with the Board's sanctioned goals and risk appetite. Certain risk-limits for non-mortgage liquidity investments may be expressed in terms of how they affect the Enterprise's overall risk-

profile, such as those pertaining to interest-rate sensitivity. Other risk limits may be more appropriately expressed in terms of individual portfolios and instruments. In addition, limits restricting the size-range and scope of the non-mortgage liquidity investment activities should be established.

b. The limits and procedures should delineate the acceptable investment instruments, acceptable markets, acceptable counterparties, along with unacceptable investment or portfolio activities. The Enterprise should maintain sufficient documentation to demonstrate due diligence in adhering to policies, procedures, limits and guidelines.

c. At a minimum, limits should be established and reviewed annually, for:

i. Credit threshold guidelines: Credit quality is a compelling factor for liquidity investments. Since liquidity investments should be able to be readily converted into cash without substantial exposure to losses, investments should be insulated from price vulnerabilities that are associated with creditworthiness. The most effective means of insulating against price exposure from credit quality concerns is to invest in high-quality instruments and the debt obligations of high-quality issuers. The Enterprise should establish thresholds identifying the minimum credit standards of any security eligible for purchase. Where these standards involve credit ratings, the ratings should come from a nationally recognized rating organization. Procedures should be included that determine the steps to be taken by management if an instrument's credit rating falls below the minimum threshold before maturity.

ii. Maturity guidelines: Because the maturity of an investment significantly affects its exposure to credit risk and price volatility, longer maturity instruments have limited suitability as liquidity investments. The Enterprise should establish the maximum maturity allowable for non-mortgage liquidity investments. It would be appropriate to have different maturity limits for certain types of instruments. For example, management may wish to establish shorter maturity limits for fixed-coupon instruments than for adjustable-rate securities. Management may have different maturity limits for bullet securities and amortizing structures. It would be appropriate to establish a maturity matrix based upon an instrument's credit rating at the time of purchase.

iii. Diversification and concentration guidelines: Credit concentrations can increase credit risk. Accordingly, the Enterprise should establish guidelines that limit investments in the securities of any single issuer. Such limits may be established as a percentage limit (*e.g.*, as a percentage of capital) or as an absolute dollar amount. To enhance portfolio liquidity, there should also

be a limit on the percentage of any particular issue held by the Enterprise.

4. Quality Controls and Personnel Administering and Governing the Process

a. The Enterprise should maintain a comprehensive set of controls to enforce the appropriate separation of duties and responsibilities. These controls should translate into clear procedures for routine operations. At a minimum, the internal control program for non-mortgage liquidity investment activities should include procedures for the following: portfolio valuation, personnel, settlement, physical control and documentation, conflict of interest, and accounting.

i. Portfolio valuation procedures. Portfolio valuation procedures should require pricing that is independent of the investment portfolio managers. Pricing securities provides an indication of the market depth and liquidity for individual instruments, and is an important process for providing data to the risk management function, particularly within a framework of estimating market value sensitivity. Pricing is particularly important for securities that are classified as "available-for-sale" for accounting purposes.

ii. Personnel guidelines. Personnel guidelines should require competent and experienced staff be responsible for conducting transactions and managing the non-mortgage investment portfolio. There should be clear guidance regarding the roles and responsibilities of individuals involved with the non-mortgage liquidity portfolio.

iii. Settlement practices. Procedures should cover standard settlement practices for the various types of non-mortgage liquidity investments in the Enterprise's portfolio. Inadequate understanding of standard settlement practices, coupled with poor internal controls, could result in unnecessary costs or losses.

iv. Control and documentation. Procedures covering control and documentation should be comprehensive and consistent with the evolving better practices in the marketplace. The procedures should include, for example, standards for: processing and controlling purchased instruments, safeguarding investment documentation and reviewing trade tickets and confirmations.

v. Conflict of interest. Conflict of interest guidelines should govern all Enterprise personnel authorized to purchase or sell non-mortgage liquidity investments. These guidelines should ensure that all directors, officers and employees act in the Enterprise's best interest. Conflict of interest guidelines should address employee relationships with authorized broker/dealers. Guidelines should also address personnel accepting gifts and travel expenses from broker/dealers.

vi. Accounting. Accounting practices should be evaluated to determine the level of compliance with GAAP standards.

5. Independent Testing and Review of the Process To Assure Compliance

a. An independent review of non-mortgage liquidity investment activities should be conducted periodically to ensure:

i. The accuracy and integrity of information provided to the Board, management and other oversight bodies;

ii. The adherence to policy, procedures, limits and guidelines;

iii. The timeliness, accuracy and usefulness of non-mortgage investment reports;

iv. The adequacy of personnel resources and capabilities; and

v. The non-mortgage liquidity investment activities remain appropriate in the context of the marketplace and the external environment.

b. This review may be conducted by a risk oversight unit or internal audit department, or any party that is independent of the routine risk-taking decisions and should be commensurate with the level of review of other primary Enterprise activities. Independent review findings for non-mortgage liquidity investments should be reported to the Board directly or through one of its committees. The Board should consider the independent review when reaffirming policies, and should address any issues raised.

D—DISCLOSURE OF NON-MORTGAGE LIQUIDITY INVESTMENT ACTIVITIES

1. Sound risk management practices include thorough disclosures about the Enterprise's risks and further regulators' efforts to increase financial transparency for regulated financial companies. Quality disclosures about risks and risk management can be an effective deterrent to excessive risk-taking. Three essential elements needed to promote market discipline for non-mortgage liquidity investments are (1) type of issuer and security, (2) maturity, and (3) credit quality or rating. Accordingly, quality disclosure for a portfolio of non-mortgage liquidity investments should include a detailed categorization of the portfolio with respect to each of these elements and cross-categorization, so that (for example) the quantity of any longer-maturity, lower-credit-quality assets is clearly identified. Information about fair values; yields; and narrative discussions of objectives, risk management policies, and controls can also promote transparency of risk and should be included. Such disclosures should be made quarterly, and they should be made using average balances so that average risks can be assessed—not just the risks on a given date.

2. Over the next few quarters, OFHEO will discuss more specifically with the Enterprise

how these disclosures will meet the expectations expressed in this guidance. An example of a disclosure format that may be used by the Enterprise is available on the OFHEO Web site at <http://www.ofheo.gov>. However, the Enterprise may disclose the risks in its non-mortgage liquidity investment activities, consistent with the expectations expressed in this guidance, using a format of its choice.

E—SUMMARY

This Guidance sets forth OFHEO's process for evaluating the safety and soundness of liquidity non-mortgage investment activities. OFHEO remains committed to ensuring the Enterprises remain financially sound, have appropriate control environments, and engage only in financially sound business and investment activities. OFHEO's examiners have been instructed to incorporate this evaluation process into their ongoing safety and soundness examinations. Examiners will evaluate and test the Enterprise's non-mortgage liquidity investment processes and activities to ensure they are in compliance with this guidance.

APPENDIX C TO PART 1720—POLICY GUIDANCE; SAFETY AND SOUNDNESS STANDARDS FOR INFORMATION

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A—INTRODUCTION

The Policy Guidance on Safety and Soundness Standards for Information sets forth standards pursuant to section 1313 of the Federal Housing Enterprise Safety and Soundness Act (12 U.S.C. 4513). The Guidance addresses standards for developing and implementing administrative, technical, and physical safeguards to protect the security, confidentiality, and integrity of information.

1. *Scope.* The Guidance applies to information maintained by or on behalf of the Fed-

eral National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (collectively, the Enterprises).

2. *Preservation of Existing Authority.* Nothing in the Guidance in any way limits the authority of OFHEO to otherwise address unsafe or unsound conditions or practices or violations of applicable law, regulation or supervisory order. Action referencing the Policy Guidance may be taken separate from, in conjunction with or in addition to any other enforcement action available to OFHEO. Compliance with the Policy Guidance in general would not preclude a finding by the agency that an Enterprise is otherwise engaged in a specific unsafe or unsound practice or is in an unsafe or unsound condition, or requiring corrective or remedial action with regard to such practice or condition. That is, supervisory action is not precluded against an Enterprise that has not been cited for a deficiency under the Policy Guidance. Conversely, an Enterprise's failure to comply with one of the supervisory requirements set forth in the Policy Guidance may not warrant a formal supervisory response from OFHEO, if the agency determines the matter may be otherwise addressed in a satisfactory manner. For example, OFHEO may require the submission of a plan to achieve compliance with the particular requirement or standard without taking any other enforcement action.

3. *Definitions.* For purposes of the Guidance, the following definitions apply:

a. *Information* means any record of an Enterprise, whether in paper, electronic, or other form, that is handled or maintained by or on behalf of an Enterprise;

b. *Information security program* means the administrative, technical, or physical safeguards used by an Enterprise to access, collect, process, store, use, transmit, dispose of, or otherwise handle information;

c. *Information systems* means any methods used to access, collect, store, use, transmit, protect, or dispose of information;

d. *Service provider* means any person or entity, including any third party vendor, that maintains, processes or otherwise is permitted access to information through its provision of services directly or indirectly to an Enterprise.

B—SAFETY AND SOUNDNESS STANDARDS FOR INFORMATION

1. *Information Security Program.* Each Enterprise shall implement a comprehensive written information security program that includes administrative, technical, and physical safeguards appropriate to the nature and scope of its activities. While all parts of the Enterprise are not required to implement a uniform set of policies, all elements of the information security program must be coordinated.